No. 10352

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

HELM AND SMITH SYNDICATE,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF.

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ARGUMENT.

I.

The Legal Relationships Existing Between Petitioners and Outside Parties, During the Period When No Trust Agreement Was in Effect, Go to the Substance Rather Than the Form of the Controversy.

Since this case first arose, respondent has sought to brush aside the fact that at the time that the bulk[1] of the income in controversy was realized, there was no trust agreement in effect as between the members of petitioner-syndicate.

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[1]Petitioners concede that some income was realized while the trust agreements were in effect, as pointed out by respondent in the footnote on page 23 of his brief.

By so doing, respondent believes himself entitled to ascribe legal characteristics to the organization, during this period, which it did not have, and to overlook the fact that, during said period, it had characteristics, which are the antithesis of those required to establish the "association" status contemplated by the law.

On page 24 of respondent's brief the lack of existence of a trust agreement is described as a "technicality," reliance on which by petitioner is said to be a subordination of substance to form.

For all respondent's claims that this fact is a mere technicality he has not and cannot overcome petitioners' showing that upon revocation of the trust agreement petitioners lost all the economic benefits attributable thereto and exposed themselves to all the obligations and hazards of doing business as joint venturers or principals and agent. However vigorously respondent struggles to escape admitting it, the facts are:

1. That petitioners revoked the trust for the purpose of enabling them to consummate certain oil leases without the necessity of the complicated proceedings required by a trustee.[2]

2. That upon revocation of the trust agreement the rights, powers, privileges, immunities and obligations of the petitioners were no longer governed by that agreement but by the unwritten agreement that Helm should lease petitioners' property as their agent and co-adventurer. [R. 181.]

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[2]Admitted by respondent's brief, page 23; also stipulated [R. 27].

3. That since, after revocation, Helm acted with the consent and on the authority of the nine co-owners, they would each have been legally liable for any obligation incurred by Helm within the scope of his authority.

4. That since, after revocation, Helm acted by virtue of the authority vested in him by the co-owners, such authority could have been revoked by any co-owner; any co-owner could have demanded partition of the property, and, the death of either Helm or any co-owner would have revoked Helm's authority to act.

5. That during this period no one of the co-owners had any interest which was transferable or assignable without revoking Helm's authority to act, or which even remotely resembled the assignability characteristic of shares of corporate stock.

6. That title to the land was held in the name of Helm, an individual, whose death would profoundly have affected the continuity of the enterprise.

The hazards which the petitioners incurred by revoking the trust in order to consummate contracts with the oil companies were bottomed in the basic laws of contract, agency and property. Upon these legal relationships rested the economic benefits and burdens (and *a fortiori* the *substance*) involved in the transactions conducted by the petitioners.

When, therefore, respondent says that petitioners' assertions are not in accord with the facts[3] he does so in contradiction to facts to which *hc* has stipulated.[4]

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[3]Respondent's brief, pages 12, 13, 15 and 16.

[4]Respondent stipulated that the trust was revoked for purposes associated with *bona fide* business transactions [R. 27].

That the revoked trust was subsequently re-established by the petitioner does not alter the fact that in transacting business respecting the land they acted in a manner utterly distinct from and dissimilar to the manner in which corporations act. The economic benefits which they enjoyed and the burdens and hazards they incurred were those of co-adventurers or principals. That was the *substance* of the situation.

In his brief (pp. 12-13) respondent states that petitioners' reference (on pp. 19-20 of their brief) to the provisions of the California Civil Code have no pertinency in this case and are not in accord with the facts. The portions of petitioners' brief to which respondent refers constituted the discussion of the legal characteristics of the organization at the time *no* trust agreement was in effect.[5]

Thus it is *respondent's* argument which is not pertinent under the facts; for only by adopting the fiction that Helm acted as a trustee, even though his trusteeship had been revoked, can respondent find a basis for those legal characteristics which he must establish to prevail.

In the absence of a trust relationship the rights, powers, obligations and immunities of the parties necessarily have to be determined from the basic law of California in the light of all the facts. Once those matters are established it is then necessary to determine whether, under the federal taxing statutes, these legal characteristics bear such similarity to those of a corporation as to render petitioner-syndicate taxable as such.[6]

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[5]See heading, page 18, petitioners' opening brief.

[6]When petitioners use the words "legal characteristics" such words are intended to mean the legal characteristics which determine economic benefits and burdens. "Similarity" when so used means similarity of economic benefits and burdens, not similarity of forms.

Petitioners think it obvious for the reasons set forth in their Opening Brief (pp. 18-23), that the similarities of the corporate form of business enterprise were utterly lacking during this crucial period.

II.

During the Period in Which the Trust Agreements Were in Effect Petitioners' Organization Lacked the Essential Elements of an Association or Corporation as Contemplated by the Law.

Respondent insists[7] that it is resemblance, not identity to the corporate form of enterprise which renders an unincorporated group an association. Petitioners have no quarrel with that proposition and regard *Bert v. Helvering,*[8] as a sound exposition of the principle that the similarities and dissimilarities of an organization to the corporate enterprise must be weighed to determine status of the taxpayer.

Respondent, however, in discussing the various characteristics of petitioner-syndicate repeatedly uses words to the effect that this feature or that is merely a further resemblance to, or a feature distinguished from, those of a corporation.[9]

Now obviously while one dissimilar characteristic alone may not be sufficient to distinguish an organization from a corporation, each feature added to the dissimilar side of the scales brings the organization farther over the line of distinction.

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[7]Pages 8, 14, 15 and 16 of his brief.

[8]92 F.(2d) 491 (App. D. C.), quoted on page 17 of respondent's brief.

[9]Respondent's brief, pages 14, 15 and 16.

This is the nub of petitioners' argument in this case. The Tax Court[10] admitted that this was a border line case, yet failed to consider or make findings respecting certain essential characteristics of the organization. In this we think the Tax Court erred, because a consideration of those characteristics discloses, as a matter of law, greater dissimilarity than similarity to the corporate form of enterprise.

In the first place it failed utterly to consider the economic benefits and burdens attributable to the relationship of the parties during the period when no trust was in effect. By virtue of the nature of the relationship of the parties, during this period, the participants were subject to all the risks and hazards, including personal liability and lack of continuity of the enterprise, to which partners are subject.[11]

Secondly, even under the trust form, the participants did not limit their liability for obligations incurred in the venture to the property embarked in the enterprise.[12]

Respondent (Brief pp. 15-16) seeks to avoid this feature by saying that the liability of the participants was not unlimited and that the trust agreement "seems to recognize that personal liability of the participants was limited to the trust property." The record shows that nothing in the agreement in any way limited the amount which participants could be called upon to pay. The provision for selling a participant's interest was additional

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[10]R. 19.

[11]See Commissioner's Regulations 101, Arts. 901-1 and 901-4, pages 28-30, respondent's brief.

[12]*Morrissey v. Commissioner,* 296 U. S. 344, 359, 56 S. Ct. 289, 80 L. Ed. 263.

security for the performance of his obligations and in no way limited the extent of such obligations.

Thirdly, while transferability of beneficial interests is not of itself a controlling factor, in this case it is another *feature* of the organization which is dissimilar to the corporation. The lack of transferable certificates (not lacking in the *Morrissey* case, *supra*) has been held by this Court to be a feature of dissimilarity.[13] Moreover, in the instant case, assignment was possible only upon the assumption by the assignee of the obligations of the assignor regarding the property. [R. 60 and 189.] Such assignability involves *economic burdens and hazards* not incurred by the owner of corporate stock, and the mere *fact* of assignability here does not reduce those hazards one whit.

Fourth, respondent seeks to avoid petitioners' argument as to the continuity of the enterprise by stating that it is doubtful whether Section 2280 of the California Civil Code applies to business trusts.[14] It happens that the *Goldwater* case was decided in 1930. The amendment to Section 2280 of the Civil Code making all trusts revocable unless *expressly* made irrevocable was not added to the Code until 1931.[15]

It will be noted also that the Code, Section 2280, says that "*every* voluntary trust shall be revocable." There are no exceptions unless made in the trust instrument. (Emphasis ours.)

There are other kinds of continuity, which the corporate form of enterprise affords, than the continuity which is

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[13]*Commissioner v. Gerstle*, 95 F.(2d) 587, 589.

[14]Citing *Goldwater v. Oltman*, 210 Cal. 408, 292 Pac. 624.

[15]Amended Stats. 1931, p. 1955.

unaffected by death. As a matter of economic benefit and burden the interruption of continuity by the death of a participant is often less bothersome than the interruption which occurs when one participant decides for some reason or other that he will withdraw. By so doing he may withdraw sufficient assets to upset the entire enterprise. Such was the situation here, where, under Civil Code, Section 2280, any participant could revoke the trust and demand a partition of his share of the land. No corporation or stockholder runs such risks. This dissimilarity to the corporate enterprise is vital to this case.

Fifth, in the matter of management, Helm did *not* have the complete powers. His powers were limited to holding, "legal title, * * * to manage and control the *same* [legal title], to sell, convey, lease, including oil and gas leases, * * * to encumber the same and to execute and deliver any such conveyances, encumbrances, leases and oil and gas leases, providing, however, said trustee shall first have obtained from the committee hereinafter provided, written consent to so execute and deliver such conveyances, leases * * *." (Emphasis ours.) [R. 58.]

Helm had no power to operate the property for business purposes. His powers were limited to making certain specific dispositions of the property and even these were subject to the consent of the participants' committee. Thus, in substance, Helm was not a manager at all but a mere repository of title.[16]

Commissioner v. Gibbs-Preyer Trusts, Nos. 1 & 2, 117 F. (2d) 619;

Cleveland Trust Co. v. Commissioner, 115 F. (2d) 481.

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[16]*Cf. Commissioner v. Gerstle, supra.*

In the latter case it was said:

> "The mere receipt of income from leased property and its distribution to *cestuis que trustent* amounts to no more than receiving the ordinary fruits that arise from the ownership of property and does not constitute doing business. * * *"

The respondent's efforts to distinguish the *Gerstle*[17] and *Rector & Davidson*[18] cases from the instant one are inconclusive.

Respondent suggests (page 20 of his brief) that the Circuit Courts in those cases merely affirmed the Board of Tax Appeals. We do not think the appellate tribunals abdicated their judicial functions in either case, but decided the cases on legal grounds which they believed produced the correct answer.

Respondent says (Brief, p. 21) that in the *Gerstle* case the syndicate members were considered equitable owners of the land, whereas here the petitioners have merely a right to the performance of the trust.

We are unable to find a basis for such distinction. In both cases the parties purchased undivided interests in land, title to which was taken in the name of one or more of their number. In both cases a committee of the participants was designated to act for all as managers. In each case legal title to the land was held, at certain times, by trustees.[19] In each case, members of the syndicate were obligated to contribute the money required to purchase

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[17]*Commissioner v. Gerstle, supra.*

[18]*Commissioner v. Rector & Davidson,* 111 F.(2d) 332; certiorari denied, 311 U. S. 672.

[19]Here Helm was trustee for title; in the *Gerstle* case certain title companies performed that function.

the property and to provide for its protection. In each case the *members themselves,* not a trust entity, assumed and undertook to discharge any obligations arising out of the venture in respect of the property. These are the characteristics of *ownership* (albeit equitable) as distinguished from a mere claim for a share of gains from a separate business enterprise. This Court in the *Gerstle* case said:

> "It seems clear that the members were equitable owners of the real property acquired, and that their beneficial interests were not merely personal claims against the syndicate managers."

Respondent claims a further distinction between the two cases, saying (Brief, p. 21) that no assignment by any member in the *Gerstle* case was to release him from liability unless the syndicate managers so agreed. Such a distinction affords respondent no comfort for in each of the two cases the assignee became liable for debts and obligations of the venture over and beyond the property embarked in the enterprise. This Court in the *Gerstle* case considered the assignability of interest there present as legally dissimilar to the assignability of corporate stock when it said:[20]

> "Their beneficial interests were not readily or conveniently transferable. There were no shares, certificate, or other evidence of interest beyond each member's copy of the agreement."

Exactly the same situation existed in the instant case in respect of the assignability of the interests of the petitioners.

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[20]Opinion, page 589.

In a final effort at distinction respondent claims that while liability in the *Gerstle* case was not limited such "does not appear to have been the situation here." (Brief, p. 21.) That contention is fully answered by the following quotations:

> "The trustee shall ascertain and pay any amount of principal and interest which may become due and payable * * * upon *any* encumbrances hereinafter placed upon said property including taxes and assessments, providing, however, that each of the beneficiaries shall provide their proportion of the funds necessary for the payment of the same * * *." [R. 58.]

The foregoing provision appears in the agreement of the petitioners in the instant case.

> "* * * It was provided that each member on executing the agreement should set down after his name the amount he would contribute to the operations, 'and his interest in the properties, profits, obligations, debts and losses of the syndicate shall be that proportion thereof which the amount set after his signature bears to the total of the amounts set after the signatures of all the syndicate members.' It was agreed that the funds required for the operations of the syndicate should be provided by the members, who were to pay to the managers, on call, their respective proportions of the total sum called for, 'provided that no syndicate member shall be called upon, prior to the termination of the syndicate, to pay a greater aggregate amount than that set after his signature hereto.' The mangers were empowered to borrow money in their own names or in the names of others for the benefit of the syndicate, and the members were liable for the repayment thereof in proportion to their respective interests. * * *."

The foregoing language taken from the opinion in the *Gerstle* case shows that the obligations assumed by the participants in both of these cases were almost identical, the only differences being those of phraseology. Respondent's contention that the cases are distinguishable on this ground manifestly does not bear analysis.

A thorough analysis of the *Gerstle* case discloses such a marked similarity to this case in respect of the economic benefits enjoyed and the burdens and hazards assumed that the instant case could be decided on the authority of that case alone. Many of the provisions of the agreement between the participants are identical in substance if not in form of phraseology. The instant case, however, is even stronger in that when the parties came to the point of entering into important binding contractual obligations, they revoked the trust and appointed Helm their sole agent to act for them in leasing the land. Thus the trust here is shown to have been not a device for doing business but a device for holding title. The powers conferred on Helm therein were incident to that purpose.

Conclusion.

The organization of these petitioners was neither an association nor a corporation during any portion of the year 1938, as contemplated by the law.

The decision of the Tax Court should be reversed.

Respectfully submitted,

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